Daily Comment

By Bill O'Grady, Kaisa Stucke, and Thomas Wash

[Posted: June 27, 2017—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1% from the prior close. Chinese markets were down, with the Shanghai composite down 0.2% and the Shenzhen index down 0.1%. U.S. equity index futures are signaling a lower open.

BREAKING NEWS: THE IMF HAS LOWERED U.S. GDP GROWTH FORECASTS FOR 2017-18. GROWTH FOR 2017 WAS CUT TO 2.1% FROM 2.3%. FOR 2018, THE FORECAST FALLS TO 2.1% FROM 2.5%. LACK OF FISCAL SPENDING ON INFRASTRUCTURE AND LACK OF TAX REFORM WERE CITED.

Here are the news items we are watching:

Draghi the hawk? ECB President Draghi gave a speech overnight where he offered a rather upbeat assessment of the Eurozone economy. He suggested that growth is picking up, headwinds are abating and inflation is likely to rise. Despite these improvements, he argued for continued monetary stimulus. The financial markets are taking the speech as a precursor to eventual policy tightening; the EUR is up sharply this morning and commodities are rebounding off of recent lows.

Trump administration warns Syria: Late yesterday, the White House issued a press statement warning Syria that another chemical weapons attack would invite a response from the U.S. and the Assad regime "would pay a heavy price" if it uses these weapons. The U.S. is suggesting that it has intelligence that Syria was taking steps to deploy these weapons. Such public warnings coming directly from the White House are unusual; normally, this type of warning would have been sent from the Defense Department or State Department. It would appear the president is taking a personal interest in this situation. If Assad defies the U.S. there would almost certainly be a response given the White House statement, which could lead to a situation of Iran and Russia against the U.S.

Filling the Fed Governor vacancies: The administration has apparently decided that it wants to announce all three vacant Fed governor positions at the same time. Randal Quarles and Marvin Goodfriend appear to have the inside track on two of the positions but the remaining position traditionally goes to a community banker to offer some representation from small banks on the FOMC. The Trump administration is facing a similar problem to what the Obama administration faced—Fed rules require divestiture of ownership in most cases and that is an unattractive requirement. So far, three candidates have withdrawn their participation because they didn't want to sell their interests in their bank affiliations. The delay in filling these spots reduces the administration's influence on the FOMC and it would behoove them to act sooner rather than later.

The Italian job: Yesterday, we noted that Italy bent EU banking rules to bail out two banks with taxpayer funds while protecting bondholders. The backlash has now begun in earnest. Germany is apparently furious with Italy's behavior and is pressing Brussels to tighten rules to prevent bondholders from being protected while taxpayers are hit with the bailout. Germany's concern is that, eventually, the Eurozone will have a unified banking system and it doesn't want its taxpayers to be bailing out bank bondholders in other countries. Italy argued that the failure of the two banks would not bring systemic risk to the Eurozone and thus could be resolved using Italian regulations. The real problem was that most of the senior bondholders were ordinary depositors who were sold the bonds as savings alternatives. The political fallout from liquidating the bondholders before the taxpayers would have been a major problem. We will be watching for whether Germany can force the EU to close the loophole Italy used for this bailout. If Germany can, future bank failures will tend to put senior bondholders at risk. At the same time, bank failures always run the risk of becoming unexpectedly systemic and it seems unrealistic for Berlin to expect that Eurozone nations will allow a small bank to implode their national financial systems. We still expect the Eurozone to eventually shrink due to the inconsistencies between Germany's goals and the inability of much of the Eurozone to achieve Germany's position.

May has a government: Yesterday, PM May officially built a coalition of the Tories and the Democratic Unionist Party (DUP) of Northern Ireland. It's mostly a marriage of convenience and may not last. The DUP, first and foremost, received money; Northern Ireland is going to get an additional £1.0 bn in extra spending over the next two years. The agreement could potentially upset the delicate peace process in this area of the U.K. Currently, Northern Ireland has some degree of self-governance (devolution), but only if the Catholics and Protestant parties can agree (the DUP represents the latter). The DUP was able to place strongly unionist language in the coalition agreement which will not sit well with the Catholic parties. It is possible that London will need to take over the government in Northern Ireland if the two groups can't agree. The other problem is that the DUP is a "soft Brexit" party; although it did support Brexit last year, it does not want a hard border with Ireland as would be necessary if the Brexit agreement with the EU is strict. Thus, the DUP could rebel if the May government pushes a hard Brexit policy. On the other hand, this coalition may force May into a softer position on Brexit which could lead to a backbench revolt within the Tories. Finally, the DUP is a socially conservative party that holds many positions the Tories find distasteful. All this leads us to believe that this government may not have staying power.

Growing tensions with China: Axios is reporting that the White House is becoming jaded with China. The hope was that by offering trade concessions China would ratchet up pressure on North Korea. The realization is setting in that Beijing isn't ever going to put enough pressure on Pyongyang to stop its nuclear weapons program. This was apparently the reason for inviting Indian PM Modi to Washington. India is a geopolitical rival to China and the optics of the warm embrace won't be lost on Chinese leaders. It should be noted that Reuters reported yesterday that the U.S. plans to place China on its global list of worst offenders of human trafficking and forced labor. The State Department compiles this report but there are leaks that indicate SOS Tillerson has decided to put China into "Tier 3," the lowest grade, suggesting it is among the worst offenders. In the 2016 report, Tier 3 nations included Iran, Russia, Sudan, Syria, Venezuela, North Korea, et al. If this leak is true, it will anger China and suggest deteriorating relations.

U.S. Economic Releases

The S&P CoreLogic Case-Schiller 20-City Home Price Index for April came in below expectations at 0.28% compared to the forecast of 0.50% from the prior month. The prior report's gain was revised downward from 0.87% to 0.53%. The S&P CoreLogic Case-Schiller U.S. HPI increased by 5.50% from the prior year. The prior report was revised downward from 5.75% to 5.63%.

The table below shows the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Conference Board Consumer Confidence	m/m	jun	116.0	117.9	**
10:00	Conference Board Present Situation	m/m	jun		140.7	**
10:00	Conference Board Expectations	m/m	jun		102.6	**
10:00	Richmond Fed Manufacturing Index	m/m	jun	5	1	**
Fed speakers or events						
EST	Speaker or event	District or position				
11:00	Patrick Harker Speaks on Economy in London	President of the Federal Reserve Bank of Philadelphia				
13:00	Janet Yellen Speaks on Global Economic Issues in London	Chairman of Board of Governors of Federal Reserve				
17:30	Neel Kashkari speaks at townhall event in Michigan	President of the Federal Reserve Bank of Minneapolis				

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Industrial Profits	y/y	may	16.7%	14.0%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly	m/m	jun	111.8	112.4		**	Equity and bond neutral
New Zealand	Trade Balance	m/m	may	0.103 bn	0.578 bn	0.419 bn	**	Equity bearish, bond bullish
	Exports	m/m	may	4.95 bn	4.75 bn	4.93 bn	**	Equity and bond neutral
	Imports	m/m	may	4.85 bn	4.17 bn	4.48 bn	**	Equity and bond neutral
EUROPE								
Italy	Economic Sentiment	m/m	jun	106.4	106.2		**	Equity and bond neutral
	Manufacturing Confidence	m/m	jun	107.3	106.9	106.9	**	Equity bullish, bond bearish
	Consumer Confidence Index	m/m	jun	106.4	105.4	105.8	***	Equity bullish, bond bearish
France	Total Jobseekers	m/m	may	3.4941 mn	3.4718 mn		**	Equity and bond neutral
	Jobseekers Net Change	m/m	may	22.3	-36.3		**	Equity and bond neutral
UK	CBI Retailing Reported Sales	m/m	jun	12	2	5	*	Equity and bond neutral
	CBI Total Distributed Reported Sales	m/m	jun	17	18	15	*	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate	m/m	may	3.5%	3.6%	3.6%	***	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	129	130	-1	Up
3-mo T-bill yield (bps)	98	96	2	Neutral
TED spread (bps)	32	34	-2	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.16	2.14	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	31	31	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Neutral
pound	up			Down
franc	up			Down

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$46.39	$45.83	1.22%	Expectations of Drop in US inventories
WTI	$43.83	$43.38	1.04%	
Natural Gas	$3.05	$3.03	0.76%	
Crack Spread	$16.32	$16.02	1.90%	
12-mo strip crack	$14.66	$14.50	1.10%	
Ethanol rack	$1.67	$1.66	0.04%	
Metals				
Gold	$1,251.13	$1,244.72	0.51%	Weaker dollar
Silver	$16.66	$16.61	0.30%	
Copper contract	$264.25	$263.85	0.15%	
Grains				
Corn contract	$ 369.75	$ 367.25	0.68%	
Wheat contract	$ 469.25	$ 465.50	0.81%	
Soybeans contract	$ 921.50	$ 913.75	0.85%	
Shipping				
Baltic Dry Freight	884	870	14	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		0.0		
Distillates (mb)		0.4		
Refinery run rates (%)		-0.30%		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for the eastern region. There is no tropical cyclone activity expected for the next 48 hours.

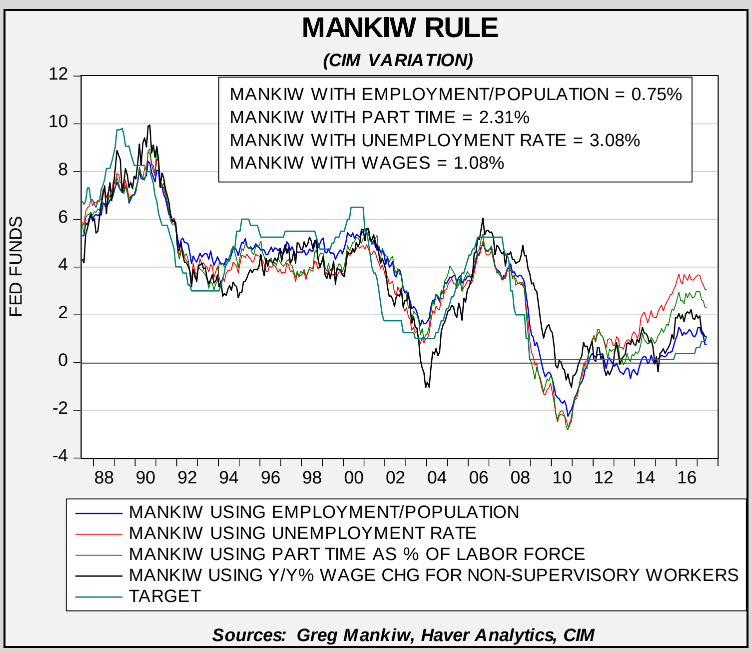
Asset Allocation Weekly Comment

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

June 23, 2017

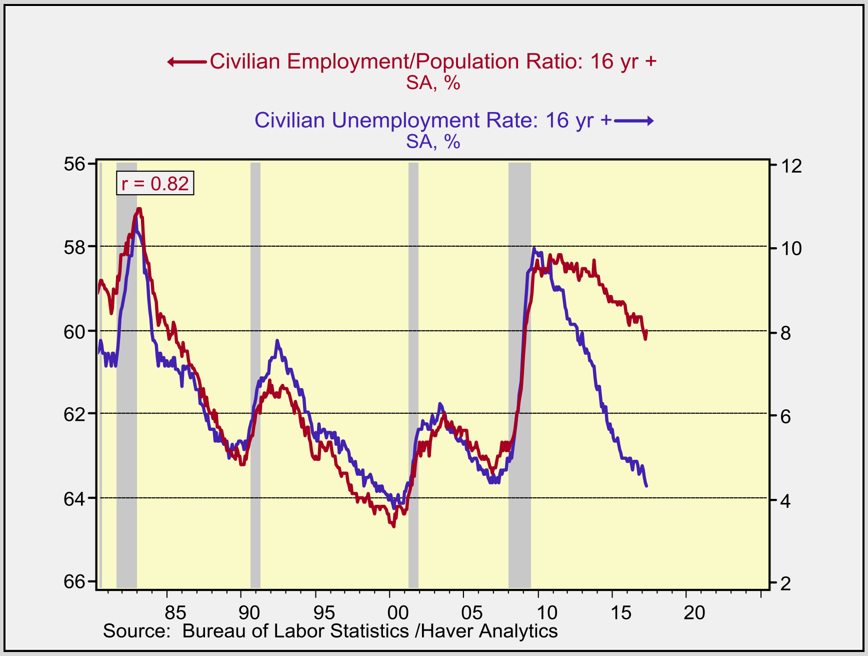
The FOMC did raise rates at the June meeting, which was fully expected. The dots chart suggested that we would see one more hike this year and three next year. In addition, the central bank gave some indication of how it would shrink its balance sheet. Although the statement didn't signal when the reduction would begin, Chair Yellen indicated in the press conference that it would begin before year's end and seemed to hint it may start much sooner than the market expects.

In this report, we want to examine two concerns we have about the path of policy tightening. The first concern is the level of the policy rate. To measure the impact of the policy rate, we use the Mankiw Rule. The Mankiw Rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.



Using the unemployment rate, the neutral rate is estimated at 3.08%. Using the employment/population ratio, the neutral rate is 0.75%. Using involuntary part-time employment, the neutral rate is 2.31%. Using wage growth for non-supervisory workers, the neutral rate is 1.08%.

The labor data has been mixed during this recovery. The unemployment rate has fallen sharply, but other measures, most notably the employment/population ratio, have fallen much more slowly.

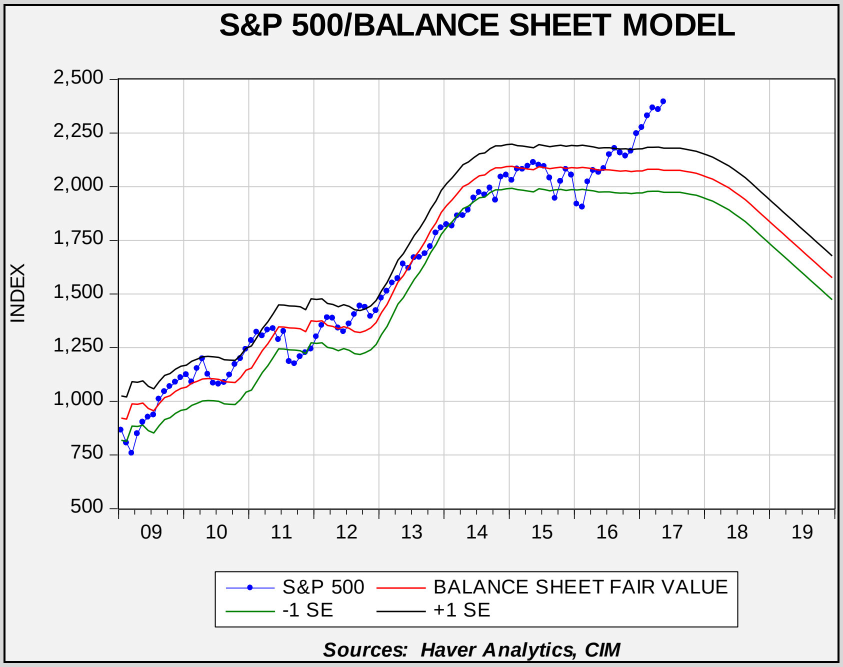


If the relationship between the unemployment rate and the employment/population ratio that existed from 1980 through 2010 had remained the same, the current unemployment rate would be closer to 7.5%. Using the above Mankiw Rule with a 7.5% unemployment rate and the current core inflation rate would generate a neutral policy rate of -0.61%! In other words, not only would the FOMC not be tightening, but cutting the balance sheet wouldn't be considered either.

The conventional wisdom is that the employment/population ratio is being affected by retirements and thus the labor market slack isn't as great as that indicator would suggest. However, we note that wage growth is much more consistent with the employment/population ratio than the unemployment rate. Thus, there is a legitimate worry that the Fed may overtighten and put the economy at risk. Currently, the financial markets only expect one more tightening over the next two years; if the dots plot is the path of policy, the odds of a recession will rise.

If the employment/population ratio is the accurate measure of slack, we are already 37 bps above neutral. Policy would be tight at 100 bps. Thus, we are two to three hikes from putting the economy at risk. Of course, the ratio could improve or inflation could rise, but without those events occurring, the risk to the economy from tighter monetary policy is rising.

The second concern is the balance sheet. The actual effect of QE on the economy is difficult to determine. We tend to think that the most likely impact was that the balance sheet expansion confirmed that the Fed was determined to execute an easy policy even with the policy rate at zero. The level of the balance sheet appears to have had a strong effect on investor sentiment.



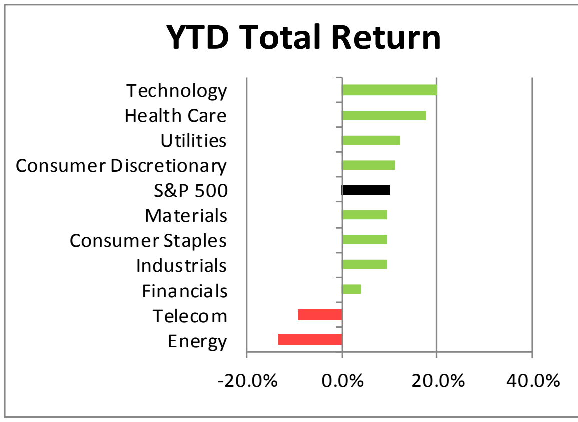
This chart forecasts the S&P 500 by using the size of the balance sheet. From 2009 into late last year, this equity index closely followed the balance sheet. After the election, equities shifted focus toward expectations of tax reform and fiscal expansion.

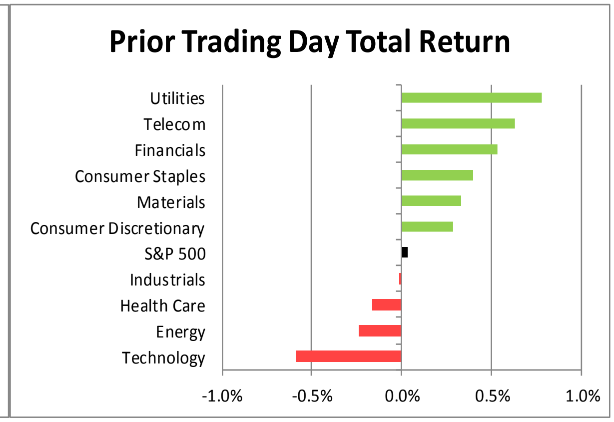
We have extended the forecast generated from the balance sheet using the FOMC's stated plan for reducing the balance sheet and assuming the reduction begins in September. The Fed intends to start slowly, only $10 bn per month, reaching $50 bn after a year. It is obvious that the balance sheet could become a headwind by 2018. This above chart isn't our forecast for equities but it does suggest that the combination of rate hikes and balance sheet reductions is signaling that monetary policy will tend to become a headwind for equities. If the Trump administration fails to move forward with tax reform or infrastructure spending, equity markets will be vulnerable to a correction.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 6/26/2017 close)

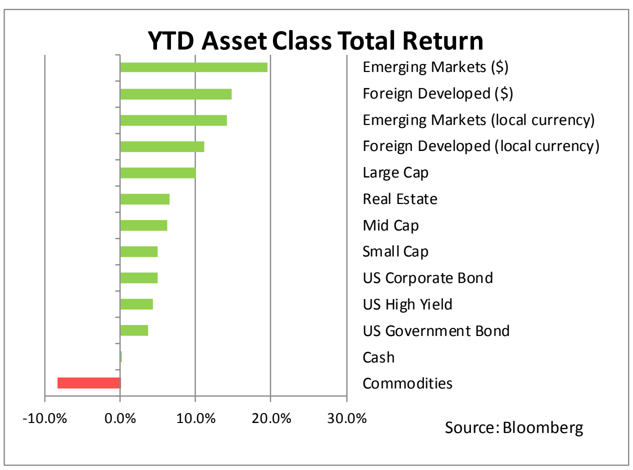




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 6/26/2017 close)

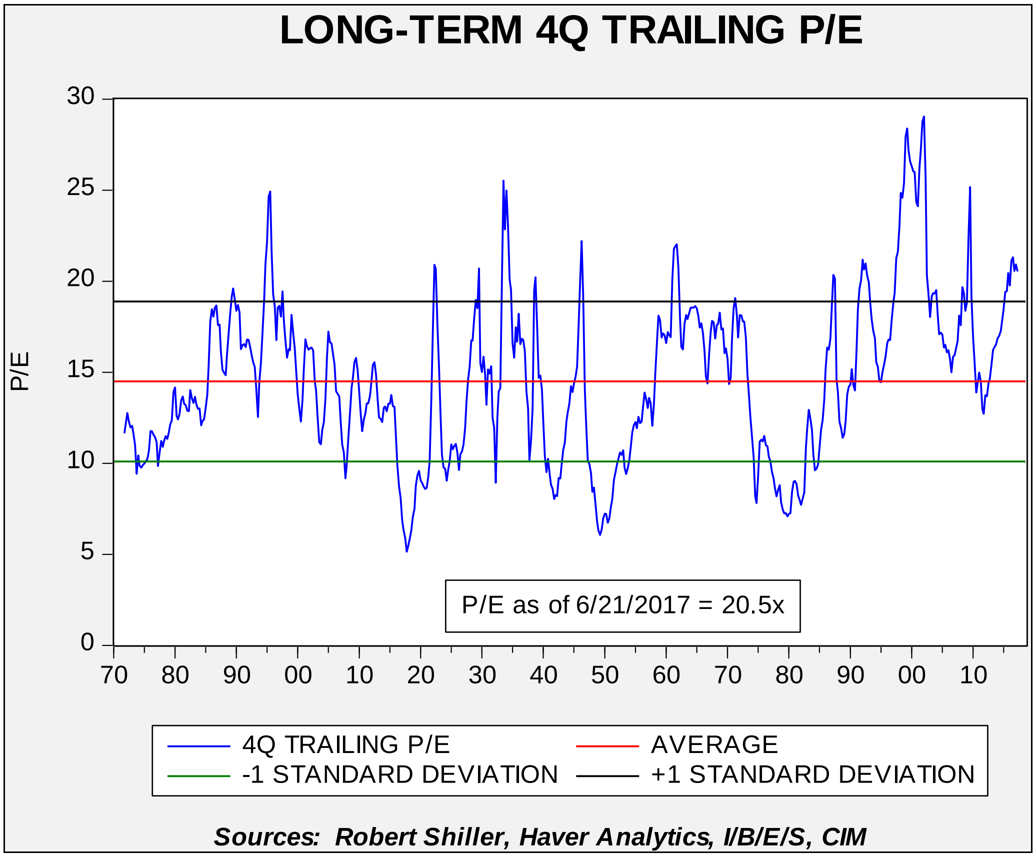


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index).

P/E Update

June 22, 2017



Based on our methodology,[1] the current P/E is 20.5x, up 0.1x from last week.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

[1] The above chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes three actual quarters (Q3, Q4 and Q1) and estimate (Q2). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a very long-term dataset for P/E ratios.